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IN THE HIGH COURT OF DELHI AT NEW DELHI

Reserved on: September 23, 2015
Date of decision: October 30, 2015

ITA 14/2013

JOHNSON MATTHEY INDIA PRIVATE LIMITED ..... Appellant
Through: Mr. Vikas Srivastava, Ms. Varsha Bhattacharya and Mr Siddharth Joshi, Advocates.

versus

DEPUTY COMMISSIONER OF INCOME TAX ..... Respondent
Through: Mr. Kamal Sawhney, Senior Standing counsel with Mr. Raghavendra Singh and Mr.Shikhar Garg, Advocates.

CORAM:
JUSTICE S. MURALIDHAR
JUSTICE VIBHU BAKHRU

J U D G M E N T
30.10.2015

Dr. S. Muralidhar, J.

1. This appeal by the Assessee under Section 260A of the Income Tax Act, 1961 (‘Act’) is directed against the impugned order dated 29th March 2012 passed by the Income Tax Appellate Tribunal (‘ITAT’) in ITA No. 344/Del/2012 for the Assessment Year (‘AY’) 2003-04.

Background facts

2. The background facts are that the Assessee Johnson Matthey India Private

Limited ('JMIPL') is engaged in the business of manufacture and sale of automobile exhaust catalysts. 90% of the shares of the Assessee Company are held by Johnson Matthey Plc. UK ('JMUK') through Matthey Finance, BV, Netherlands. JMIPL's manufacturing unit is located at IMT, Manesar in Haryana. Maruti Udyog Limited ('MUL') is a major customer of JMIPL accounting for most of its sales.

3. JMIPL and MUL agreed on an arrangement where JMIPL would sell finished catalysts to the vendors of MUL under the instructions of MUL. JMIPL used two basic raw materials for the manufacture of the catalyst i.e. precious metals and wash coated substrates. JMIPL procured the precious metals (such as Platinum, Palladium and Rhodium) from one of its associate enterprises ('AE') JMUK and the wash coated substrates from another AE, Johnson Matthey Malaysia ('JMM'). On its part, the AE (JMM) purchased raw substrates from international suppliers for further processing, performed wash coating operations on them and then supplied the wash coated substrates to JMIPL.

The agreement between JMIPL and MUL

4. JIMPL states that since the prices of precious metals in the market fluctuate heavily, it entered into a Platinum Group Metals ('PGM') Forward Cover Agreement with MUL on 6th September 2002. Schedule I to the PGM Forward Cover Agreement comprised supplementary terms and conditions of sale. Under Clause 1.1, JMIPL agreed to give a quote to Maruti for the price of a quantity of PGM to be purchased on a specified day in the future, called the 'PGM quote'. It is clarified in the same clause that "a PGM quote

shall be an invitation to treat only and not an offer."Clause 1.2 states that JMIPL would try to hold the quoted PGL price "for a period of one hour (valid period) after it has been given by JMUK to JMIPL unless agreed otherwise in writing." Clause 1.3 provided that in the event that MUL wishes to make an offer for the purchase of PGM on the basis of the PGM quote, an authorised employee of MUL would place a firm and binding order for the PGM with JMIPL by fax within the specified 'valid period' using a form set out in Schedule-2 to the agreement.

5. Schedule-2 was titled 'PGM Order Form' and set out a proforma of the instructions regarding the date of purchase, price of purchase, quantity as well as the type of PGM. Clause 1.4 gave JMIPL the discretion to accept the future order on the terms of the PGL quote by sending a fax notice to MUL. Clause 2 specified of the limits and rates as under:

> "**Limits**
> 2.1 JMIPL shall decide in its absolute discretion whether or not to offer Maruti a PGM Quote or whether to purchase PGM on the terms of the 'Supplementary Terms and Conditions of Sale.'
>
> 2.2 Although it is within JMIPL's discretion whether or not to quote PGM prices in the future on the terms of this Agreement on whether to purchase PGM on the 'Supplementary Terms and Conditions of Sale'. Maruti understands that JMIPL must always comply with its own internal risk procedures, the current procedures which JMIPL has the absolute discretion to change, being set out in Schedule 3."

6. Schedule 3 to the agreement specified 500,000 UK Pounds (UKP) as the

upper limit for the value of the future contract that JMIPL could enter into on behalf of Maruti during any one calendar month. The upper limit for the total of all future contracts that could be held by JMIPL on behalf of MUL was specified as 2 million UKP. The terms of payment were set out under Clause 3. Clause 3.1 stated that JMIPL will use the PGM bought in the manufacture of the autocatalyst products for MUL "on the supplementary conditions of sale" appended as Schedule-1 to the agreement. Under Clause 3.2 JMIPL was to invoice MUL or its canner for the price of the PGM Order plus an agreed handling charge as set out in the Supplementary Conditions of Sale. Under Clause 3.3, in the event that MUL ordered a surplus PGM which JMIPL was unable to use in the manufacture of autocatalyst products for MUL within 3 months of the maturity date of each order, such surplus PGM would become payable by MUL together with interest at the prevailing Bank of India Base Lending Rate.

7. The supplementary terms and conditions of sale were incorporated into the agreement itself. Clause 7 of the Supplementary Terms and Conditions, i.e. Schedule-1 to the agreement, set out the mechanism concerning PGM purchasing and pricing. It read as under:

> "Maruti will provide their requirement for three months. Base on their requirement for a particular month say month (n), JM will purchase metal two months prior to dispatch on daily basis i.e. in the months (n-2). The weighted average price of the purchased metal shall be incorporated in the Quotation. Maruti will ensure that the canners will raise the Purchase order for the deliveries to be made in the month (n) prior to the commencement of the supplies.
>
> Similarly if the number of pieces supplied in the month (n)

> is more than the Quoted quantity, the PGM price for the extra dispatch would be agreed on the last day of that month. The price for the extra number of pieces supplied would be worked out and the price differential in terms of value would be incorporated in the next month's Quotation i.e. in the month (n+1) and the Purchase order for the same will be raised prior to the commencement of the supplies."

8. JMIPL states that there is a 'fixed manufacturing charge per unit' of catalyst manufactured by it. These charges are determined on the basis of negotiations with customers including MUL and are amenable to revision from time to time. It is further stated that since the Assessee charges a fixed manufacturing charge, it recovers the entire cost of raw material consumed in the manufacture of the catalysts from its customers.

Proceedings before the TPO

9. JMIPL filed its return of income for AY 2003-04 on 2nd December 2003 declaring a total income of Rs.6,36,76,260. The case was picked up for scrutiny. Subsequently, the Assessing Officer ('AO') referred the case to the Transfer Pricing Officer ('TPO') under Section 92 CA (3) of the Act.

10. JMIPL had submitted a transfer pricing report to the TPO in which it had selected itself as the tested party in order to benchmark the international transaction with its AE. On the basis of functional and risk profile and on examination of the available comparable data, the Transactional Net Margin Method ('TNMM') was determined to be the most appropriate method for determining the arm's length price ('ALP'). For application of the TNMM, 'Return on Capital Employed' ('ROCE') was selected as the Profit Level

Indicator ('PLI') for all international transactions except for transactions involving sale of catalysts to the AEs for which the net profit margin, i.e., profit after tax (operating profits less operating cost) as a percentage of sales was selected as the PLI.

11. JMIPL selected a set of 11 comparable companies and on the basis of the data for Financial Year ('FY') 2002-03, the average ROCE of the comparable companies came to 18.33% which was less than that of JMIPL, i.e., 28.42%. JMIPL accordingly contended that the international transactions were at arm's length. In order to benchmark the transaction of sale of catalyst to the AEs, JMIPL's net profit margin, i.e., profit after tax as a percentage of sales in relation to export sales was determined as 6.98% and which was higher than the net margin on local sales to unrelated parties (3.73%). JMIPL, therefore, contended that the international transaction of sales to the AEs was also at ALP.

12. On 28th January 2005, the TPO passed an order setting out the various international transactions entered into by the Assessee during the AY 2002-03 by relying on the TNMM with ROCE as the PLI. The TPO stated that after discussing the matter with the authorised representatives ('ARs') of the Assessee "no adverse inference is drawn" in respect of the ALP declared in respect of the international transactions entered into by the Assessee.

13. In the order dated 22nd March 2006 for AY 2003-04, the TPO discussed the various types of PLIs and how the reliability of each could be enhanced through a number of adjustments for differences in capital employed and

functions performed. One method was the ‘Return on Operating Assets’ (‘ROA’) which refers to the return on capital employed. The next method was the Berry Ratio, or Gross Profit measured against Operating Expenses. Analysing Rule 10B(1)(e) of the Income Tax Rules, 1962 ('Rules'), the TPO noted that it did not permit ratios which use gross profit margin, and therefore, under the transfer pricing regulations, Berry ratio could not be used as a PLI. It was opined that if the income statement data was more reliable than the balance sheet data, then the financial ratio of operating margin, by which the returns to a company were tracked on the basis of the interaction between operating income and the level of sales achieved at the given level of expenditure, was the most suitable. Finally, the TPO observed that since JMIPL was engaged in the manufacturing of automobile exhaust catalysts and importing raw materials from its AEs, ROA could not be applied.

14. In the proceedings before the TPO, JMIPL was asked to substantiate its claim that the appropriate PLI was ROCE. JMIPL explained that if the OC was to be taken as a base (i.e. the denominator) then the amount considered should be such sum after the raw material cost (‘RMC’) is subtracted from the OC. In other words, JMIPL sought to benchmark the international transaction using OP/TC minus RMC. The TPO concluded that if the RMC, which was Rs. 75.85 crores, was taken away from the total cost of Rs. 84.16 crores, “the benchmarking would virtually as a percentage of overheads which is not acceptable as a profit level indicator.” According to the TPO, the return on total cost ratio was less susceptible to accounting differences. Therefore, in the present case, which pertained to a manufacturing industry,

it was observed that "OP/TC is therefore considered as appropriate PLI." The TPO concluded that:

> "The arithmetic mean of the OP/TC ratio of the comparable companies is 16.85%. Accordingly, on benchmarking the result of the assessee company with that of the comparables, the assessee should have earned a margin of 16.85% over its total cost. In this manner the arm's length price of international transaction undertaken by the assessee with its associated enterprise is calculated as under:
>
> Operating Income = Rs.88,49,97,000
> Operating Cost = Rs.82,87,41,000
> Operating Profit = Operating Income-Operating Cost
> =Rs.(88,49,97,000-2,87,41,000)
> =Rs.5,62,56,000 (y)
> (Operating Profit @ arithmetic mean of margin of comparables)
> = 16.85% x Operating Cost
> = 0.1685 x Rs.82,87,41,000
> = Rs.13,96,42,859 (z)
> Difference = (z) - (y)
> =Rs.(13,96,42,859-5,62,56,000)
> = Rs.8,33,86,859."

15. The TPO by dated 22nd March 2006 concluded that JMIPL's international transaction with JMM was not on an arm's length basis. He re-determined the value of the international transaction at Rs.62,49,06,744 instead of the reported value of Rs.70,82,93,603. He recommended an addition of Rs.8,33,86,859 to the income of JMIPL.

Proceedings before the AO, the CIT (A) and ITAT

16. The AO passed the assessment order on 29th March 2006 accepting the

order of the TPO and concluding that the difference between the average OP/TC of the comparable companies (16.85%) and that of JMIPL (6.79%) was 10.06% which was double the normal acceptable range of +/-5%. Accordingly, JMIPL's income was enhanced by Rs.8,33,86,859.

17. JMIPL's appeal against the aforementioned order was dismissed by the CIT (A) by an order dated 26th November 2009. It was observed that "since the appellant is not engaged in a seasonal business and the appellant is engaged in the manufacturing of automobile exhaust catalysts and making import of raw-material from its AE, in these circumstances, I am of the view that Return on Capital Employed is not an appropriate PLI in the case of appellant and thus the TPO was right in rejecting such PLI."

18. The above order of the CIT (A) was affirmed by the ITAT by its order dated 27th March 2012. It was, *inter alia*, observed that "the accounting of the Assessee shows that the cost of raw material is to be treated as a value added cost and not as a pass through cost. Even the AE which are using the precious metal for manufacturing catalyst raw material and they are also accounting the precious metal in the same manner in which the Assessee was doing and nowhere was it being treated as a pass through cost. All these factors showed that the Assessee's claim to treat the cost of purchase of precious metal as a pass through cost has no basis."

19. Consequently, the ITAT rejected the plea of JMIPL that the cost of raw material should not be added to the total cost.

Questions of law

20. While admitting the appeal on 9th July 2015, this Court framed the following questions of law:

> (i) Whether on the facts and in the circumstances of the case, the Tribunal erred in replacing the PLI adopted by the Assessee to determine the ALP with another PLI despite not providing any cogent reasons for the same and in fact providing contradictory remarks while rejecting Return on Capital Employed ('ROCE') as the PLI?
>
> (ii) Whether on the facts and circumstances of the case, the Tribunal erred in not treating the cost of the raw material as a pass through cost and thus rejecting the Assessee's contention that cost of the raw material should be excluded from the total cost if the alternate PLI (i.e. Operating Cost as a percentage of Total Cost excluding raw material cost) is adopted even if the raw material was ordered based on recommendations and a confirmed order by the Assessee's customer Maruti Udyog Limited?"

Submissions of counsel for the Assessee

21. It is contended by Mr. Vikas Srivastava, learned counsel for JMIPL, that the cost of the raw material is prone to price fluctuations. In order to ensure that JMIPL does not lose money on sales if the prices of raw materials increase drastically after the placement of the order, the prices at which such raw materials are to be purchased are frozen. This is an established industrial practice which ensures that both parties do not suffer on account of the frequent fluctuations in the PMG market. He submitted that a manufacturer never purchases and stocks the raw material until and unless there is a confirmed order.

22. Mr. Srivasatava referred to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010 ('OECD Guidelines'), the United States Regulation on Transfer Pricing and the Taxation Ruling TR 97/20 issued by the Australian Tax Office as well as the ICAI Guidance note on Transfer Pricing, and submitted that given that JMIPL was a contract manufacturer in a highly capital intensive industry, an asset based PLI would be appropriate. Therefore, ROCE was an appropriate PLI. ROCE would be the best indicator of profitability as long as the risks are properly accounted for. In the case of JMIPL for AYs 2002-03 to 2011-12, the Revenue had accepted that it was a contract manufacturer. Therefore any departure from the PLI employed by JMIPL, keeping in line with the guidelines aforementioned, required cogent reasons to be given. Under the economic theory of capital, capital always flowed from low return to high return activities and in time risk-adjusted return on capital would be equalized. Therefore, ROCE would be the best indicator of profitability in spite of variations in comparable functionalities as long as risks are properly accounted for. He submitted that neither the TPO nor the CIT (A) have offered any cogent reasons for rejecting ROCE as the appropriate PLI.

23. Mr. Srivasatava submitted in the alternative that if ROE was not acceptable as the PLI, the PLI of OP/TC-RCM should be used. With regard to the raw material, no function was performed by JMIPL, no risk was undertaken and no assets were employed. Therefore, no return could be expected on the raw material purchased by JMIPL. He submitted that the findings of the TPO, CIT(A) and ITAT do not take into account the fact that JMIPL was operating on a fixed manufacturing charge per unit model, being

a contract manufacturer. JMIPL's profit margin was dictated by the negotiations with MUL. JMIPL cannot possibly earn a profit based on a percentage of the raw material used in manufacturing. JMIPL has to procure raw material on the instructions of MUL, at a price dictated by it and from the source selected by MUL. If MUL had bought PGM directly from JMUK, there would have been no application of transfer pricing as MUL and JMUK were unrelated entities. MUL would have purchased PGM at the negotiated prices, as JMIPL was doing presently. Therefore, the price at which JMIPL purchased PGM from JMUK are already at arm's length. It was only for administrative convenience that MUL has outsourced its function of purchase of raw material to JMIPL but still controlled every element of such raw material, i.e. quantity, price, mode of purchase (spot/forward) etc.

24. Referring to the sample letter dated 19th March 2002 written by MUL to JMIPL, he submitted that the Assessee purchased raw materials on the specific instructions of MUL. While it was true that the actual catalyst was not sold to MUL but to MUL’s vendors, there was no agreement between JMIPL and the said vendors. JMIPL did not bear any risk in relation to majority of its cost (i.e. the cost of raw material). JMIPL did not even bear credit risk in relation to the cost of PGM as the credit period given by JMUK to JMIPL for PGM was 60/90 days, while the credit period given by JMIPL to MUL's vendors was 30 days wherein MUL guaranteed payment to JMIPL in case of the vendors' default.

25. Referring to Rule 10B(1)(e)(i), Mr. Srivastava submitted that the base, i.e., the denominator, should be determined in a manner consistent with the

business profile of the enterprise. According to him, the OECD and the US Guidelines as well as the Indian transfer pricing regulations envisaged adjustments to the cost base by excluding i certain items based on the risk profile of an enterprise. Thus, if an enterprise bears no risk in terms of inventory, raw materials etc. and these do not contribute to its returns, such items should be excluded from calculations. If, at all, the PLI of OP/TC had to be used then it had to be after deducting the cost of raw material from the total cost. The said PLI of OP/(TC-RMC) had been in use by JMIPL for AY 2004-05, 2005-06 and 2006-07 and this was accepted by the tax authorities without challenge. Invoking the rule of consistency, as expostulated in ***Radhasoami Satsang v. CIT (1992) 193 ITR 321 (SC); CIT v. Ashok Mittal (2014) 360 ITR 12 (Del); CIT v. Mohan Meakin Ltd. [2010] 189 Taxman 377 (Del) and DIT v. India Habitat Centre [2011] 203 Taxman 510 (Del)***Mr. Srivasatava submitted that no departure ought to have been made for the AY in question i.e. 2003-04.

Submissions of counsel for the Revenue

26. Countering the above submissions, Mr. Kamal Sawhney, learned Senior Standing counsel for the Revenue submitted that the attempt by JMIPL at adopting ROCE as the PLI was contrary to Rule 10 B (1) (e) (i) because assets (or capital employed) had no relationship to the international transactions, which were essentially purchase transactions. For making purchases, no assets or capital was required. Thus, cost employed was the appropriate base for calculating the net profit margin under TNMM. This approach had been adopted and upheld by the lower authorities. The fallacy in JMIPL's approach throughout was to select a base/denominator by

referring to what it did as a whole enterprise instead of referring to the international transactions that it had undertaken.

27. On the second question, Mr. Sawhney submitted that the purchase of PGM by JMIPL from JMUK was not a pass through transaction since the sale of raw material was not directly made by JMUK to MUL but it was a sale first made to JMIPL which in turn sold it to vendors of MUL. Mr. Sawhney submitted that a true pass through cost would have been where the purchasers of the final product viz. the automotive catalysts would themselves purchased the raw materials, handed it over to JMIPL as a bailee to utilize it in the manufacture of the products and then purchase the final product by paying to JMIPL a price per unit. In the present case, even through MUL had fixed the price for the precious metals and paid JMIPL the fixed price, there was nothing on record to show that JMIPL was purchasing the precious metals at the same price from its overseas AE. While MUL might finally obtain the precious metals at ALP, the international transaction between JMUK and JMIPL with regard to sale of precious metals may not be at ALP because JMIPL was a wholly owned subsidiary of JMUK. Referring to the order of the CIT (A) Mr. Sawhney pointed out that the CIT (A) had noted that JMUK at the time of selling the precious metals to JMIPL included it in its turnover and JMIPL included the corresponding purchase in its expenditure side. Once the material was processed and sold to the vendors of MUL, JMIPL included the total sale value in its turnover. Nowhere, did the accounting entries show that the materials purchased were to be treated as a pass through cost.

28. Mr. Sawhney too referred to Rule 10B(1)(e)(i) of the Act and submitted that in the absence of the agreement between JMIPL and the vendors of MUL being placed on record it could not be said that there was no value addition to the catalyst in question at the time of its sale to the vendors of MUL. If RMC was excluded from TC cost, calculation of the net margin would be a futile exercise. This was because during the year under consideration JMIPL had a total revenue of Rs. 88.49 crores against which raw material consumption was Rs. 75.85 crores. Out of total raw material consumption, purchase worth Rs. 69.28 crores was from JMUK. Thus if RMC from JMUK was excluded, very little would remain on which net margin could be computed. It was further submitted that JMIPL's argument was unsupported by the provisions of the Act and the Rules. They did not envisage removing any element from the appropriate base. Further, it would be self-contradictory to compute ALP of international transaction between JMUK and JMIL on the one hand and remove the figures pertaining to the international transaction from the computation on the other hand.

29. Mr. Sawhney next argued that the principle of *res judicata* may not apply and merely because in the earlier or subsequent AYs JMIPL's position had been accepted, it did not imply that the same must be adopted for the AY in question as well. Each year had to be considered separately. Further the principle of *res judicata* did not apply to decisions of the income tax authorities. Reliance was placed on the decisions in ***New Jehangir Vakil Mills Co. Ltd. v. CIT (1963) 49 ITR 137 (SC)*** and ***ITO v. Murlidhar Bhagwan Das (1964) 52 ITR 335 (SC)***.

Question (i)

30. The first issue that arises for consideration is whether the Revenue was right in rejecting ROCE as a PLI. JMIPL for the AY in question selected TNMM at an entity level. When for AY 2002-2003, it adopted ROCE as the PLI, the Revenue accepted it. But when it did so for the AY in question, i.e. 2003-04, the Revenue did not.

31. The Revenue does not dispute that JMIPL is a contract manufacturer in a capital intensive industry. However, that by itself need not be determinative of whether ROCE is the most appropriate PLI. Rule 10 B (1) (e) (i) of the Rules prescribes the manner of computing net profit margin under the TNMM. It envisages computing the net profit margin realised by the enterprise from an international transaction entered into with an AE in relation to costs incurred, or sales effected, or assets employed or to be employed by the enterprise, or having regard to "any other relevant base." This is more or less what para 6.28 of the ICAI Guidelines state. The question that then arises is whether given that the international transaction in question is that of purchase of raw materials by JMPIL from its foreign AE, JMUK, can ROCE be said to be an appropriate PLI?

32. The OECD Guidelines state that where PLI is "a net profit weighted to assets" it is the "operating assets" alone that should be used. These include "tangible operating fixed assets, including land and buildings, plant and equipment, operating intangible assets used in the business, such as patents and know-how, and working capital assets such as inventory and trade receivables (less trade payables)." The OECD Guidelines point out that

"investments and cash balances are generally not operating assets outside the financial industry sector." As pointed out by the TPO in the instant case, reliability of ROCE as a PLI depends upon the extent to which the composition of assets/capital deployed by the tested party and their valuation is similar to that of comparables. If operating assets reported in balance sheet do not reliably measure the capital employed, ROCE would be less reliable than financial ratios. If the balance sheet does not accurately reflect the average use of capital throughout year, ROCE would be less reliable.

33. JMIPL appears to have itself realised the limitations of adopting ROCE as the PLI for the subsequent AYs. It states that it " improved upon the PLI used in AY 2003-04 taking into account the economic realities in AY 2004-05." It explains how it arrived at the PLI of OP/TC-RMC "after excluding the cost on which no risk was undertaken by the Appellant which is also appropriate for contract manufacturers" in terms of the OECD Guidelines. In its written submissions JMIPL itself explains: "The exclusion of cost of raw material in respect of which the Appellant bears no costs or risks presents a very accurate picture of the profit margins of the Appellant. The exclusion of factors which do not affect returns is allowed under all the guidelines mentioned above. This PLI used in AYs 2004-05,2005-06 and 2006-07 was accepted without any objection by tax authorities."

34. Consequently, it appears to the Court that the rejection of ROCE as PLI by the Revenue for the AY in question is a fact that has been accepted and acted upon by JMIPL itself for the subsequent AYs when it changed its PLI

to OP/TC-RCM, which appears to have been accepted by the Revenue.

35. Question (i) is accordingly answered in the negative, i.e. in favour of the Revenue and against the Assessee.

Question (ii)

36. The clauses of the agreement between JMIPL and MUL which have been extracted hereinbefore indicate that JMIPL's profit margin is dictated by its negotiations with MUL. The clauses do bear out the submission of JMIPL that it is obliged to procure the raw material on instructions of MUL at a price dictated by MUL from the source selected by MUL. JMIPL is entitled to a per unit fixed manufacturing charge over and above the actual cost of the raw material. The submission of JMIPL that entire cost of raw materials comprising of precious metals and substrates is passed on to or recovered from the ultimate customer without any mark up has not been able to be countered b the Revenue. In other words the contention of JMIP that its profit is not at all affected by the cost of raw materials remains uncontested. The submissions of the Revenue as to what are true pass through costs fail to acknowledge the actual arrangement between JMIPL and MUL as reflected in the clauses of the agreement as well as in other documents and letters placed on record.

37. The exclusion of pass through costs from the denominator of total costs where the financial ratio of OP to TC is used is acknowledged in para 2.93 and 2.94 of the OECD Guidelines. Para 2.93 states that the extent to which it would be acceptable "at arm's length to treat a significant portion of the tax

payer's costs as pass-through costs to which no profit element is attributed (i.e. costs which are potentially excludable from the denominator of the net profit indicator)" would depend on the extent to which "an independent party in comparable circumstances would agree not to earn a mark-up on part of the costs it incurs." Para 2.94 of the OECD Guidelines further acknowledges that "comparability issues may arise in practice where limited information is available on the breakdown of the costs of the comparables." This Court has in ***CIT v. EKL Appliances Ltd. (2012) 345 ITR 241 (Del)*** has noted that the OECD Guidelines have been recognised in our tax jurisprudence. What is however, is significant is that in the absence of any reliable comparable data, and in the absence of proper reasons, it would not be justified for the Revenue to simply reject a financial ratio adopted by the Assessee for computing the net profit margin by excluding a pass though cost from the TC in the denominator. The expression "any other relevant base" occurring in Rule 10 (1) (e) (i) of the Rules is wide enough to encompass a denominator that excludes pass through costs as long it is demonstrated to be at arm's length.

38. It is further importantly pointed out that the very purpose of transfer pricing is to benchmark transactions between related parties in order to discover the true price if such entities were unrelated. If MUL had bought the PGM directly from JMUK there would have been no application of transfer pricing since MUL and JMUK are unrelated entities. MUL would have purchased the PGM just like JMIPL did on negotiated prices. There is merit in the contention that the prices at which JMIPL purchased PGM from JMUK were already at arm’s length and that it was for administrative

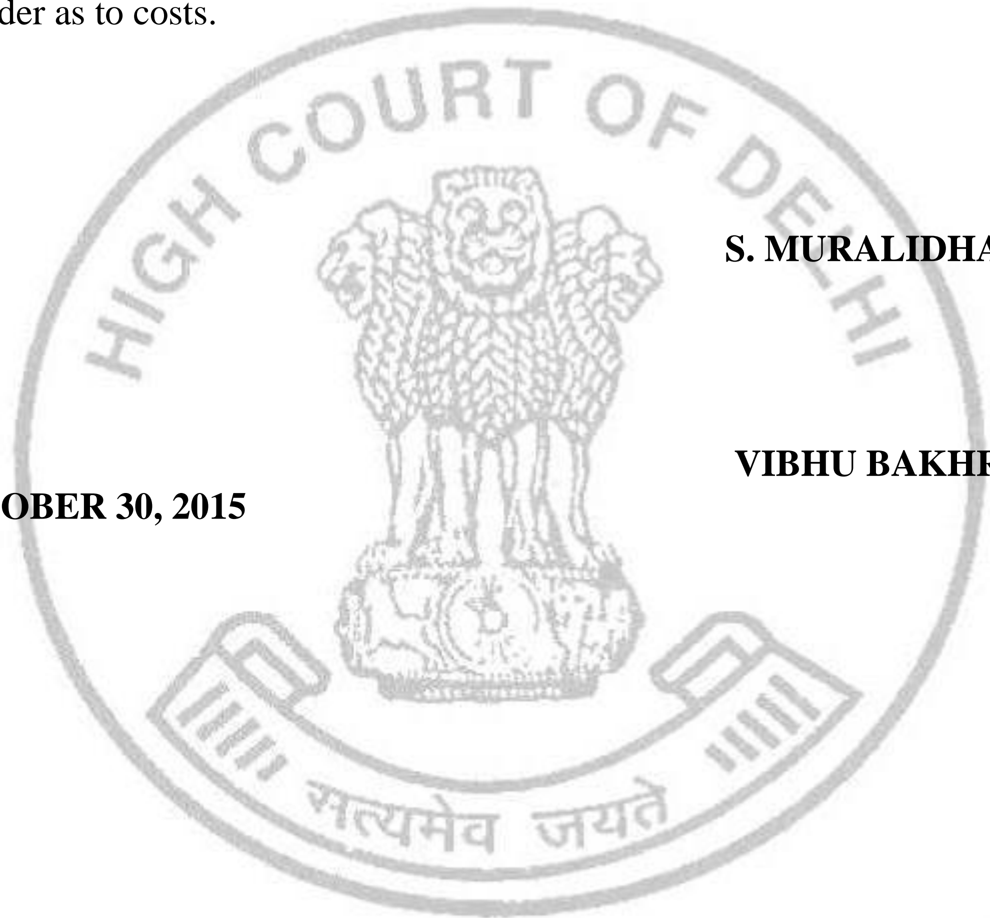
convenience that MUL had outsourced this function to JMIPL. The submission of the Revenue that the accounting entries of JMUK do not treat the cost of PGM as a pass through cost fails to acknowledge that JMUK is in the business of selling PGM. It does not require to charge JMIPL for processing the raw material i.e. PGM as that is passed on to MUL's vendors and thereby to MUL. The fact that JMIPL is paid a fixed manufacturing charge per unit shows that costs associated with the possible fluctuations in the price of the raw material is passed on to the customers and does not affect the profits of JMIPL. The submission of the Revenue that the international transaction between JMUK and JMIPL with regard to sale of precious metals may not be at ALP because JMIPL was a wholly owned subsidiary of JMUK does not appear to be based on any definite information but on suspicion. No convincing reason is forthcoming in the orders of the TPO, the CIT (A) or the ITAT for rejecting the alternate plea of JMIPL as regards the PLI being OP/TC-RMC.

39. Finally, the Revenue has been unable to deny that the above alternate computation of the net profit margin by JMIPL for the subsequent AYs 2004-05, 2005-06 and 2006-07 has been accepted by the Revenue. While as a general proposition each assessment year should merit independent consideration, the Court finds no reason why for the AY in question, i.e. 2003-04, with no distinguishing features being pointed out, the Revenue would want to reject the alternate PLI adopted by JMIPL.

40. For the above reasons, Question (ii) is answered in the affirmative, i.e in favour of the Assessee and against the Revenue. The impugned order dated

29th March 2012 of the ITAT and the corresponding orders of the TPO, the AO and the CIT (A) for AY 2003-04 are set aside. The addition directed to be made by the AO to the income of the Assessee for the AY in question is deleted.

41. The appeal is allowed in the above terms but in the circumstances with no order as to costs.



S. MURALIDHAR, J

VIBHU BAKHRU, J

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